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CREDIT AND CAPITAL MARKETS -- A SUMMER REASSESSMENT

The abrupt and steep drop in money market rates and bond yields during the spring astonished even the most seasoned financial observers, just as did the previous sharp run-up in interest rates. Similarly, the speed with which the economy seems to be rebuilding liquidity was not generally anticipated, even when it became apparent that the recession would be relatively severe. Yet the mood in the credit and capital markets is somewhat uneasy at midsummer.

Not only is there still uncertainty over the course of monetary policy in the months ahead, but concern is growing regarding the unexpectedly large Federal deficit now officially forecast for the current fiscal year, and the worsening prospects for the fiscal 1981 budget; with only a moderate tax cut effective January 1, the deficit is likely to be bigger next year. This, in turn, is creating doubts among investors whether meaningful and lasting progress can be achieved in dampening the rampant inflation. Accordingly, some financial observers are questioning whether the behaviour of the money and capital markets in the latter stages of previous recessions can be taken as a reliable guide to the credit climate and the course of interest rates from here on.

Falloff in Borrowing Though there are some grounds for debate as to the behaviour of money rates and bond yields over the rest of this year, there is no disputing the reasons for the recent unprecedented drop in interest rates, and for the development of the largely comfortable conditions that are apparent in the credit and capital markets. First, the sudden onset and the obvious momentum of the current recession, together with the unexpectedly prompt slowing of the major price indices in reaction to the weakening in business activity, brought a marked shift in sentiment in financial markets during the spring. In addition, a dramatic change has occurred in credit demands, as well as in the flows of funds within the various financial markets and institutions, which the Federal Reserve has tended to encourage.

Business borrowing from commercial banks, after rising by close to $8 billion in the January-March period of this year, declined by over $2 billion during the second quarter; by comparison, in the April-June period of 1979 commercial and industrial loans outstanding increased by almost $15 billion. An equally notable reduction can be seen recently in lending by finance companies. Indeed, the lone important sector of short-term business financing that has continued to show growth throughout the spring and into early summer is the commercial paper market; unlike bank and finance company borrowing, the sustained reliance of large companies on the commercial paper market contrasts strikingly with the pattern in late 1974, when business activity turned sharply downward.

Not only have businesses substantially reduced their short-term borrowing recently, but consumer credit has contracted to a considerable degree. Reflecting the sharp drop-off in automobile sales, but reinforced by the broad retrenchment in consumer buying in general and by the restraints on credit-card usage imposed by the Federal Reserve in mid-March and the confusion these caused among consumers, instalment credit outstanding fell in April for the first time in five years, and another—and record—drop was reported in May.

Shifting Investment Markets Extensions of home mortgage credit likewise have dropped off appreciably this year. Disintermediation and the high cost of holding deposits put a severe squeeze on the lendable funds of the thrift institutions, while the prevailing very high mortgage interest rates discouraged borrowing by households, with the result that there was a steep falloff in housing starts and in sales of both new and existing homes. Additionally, because of the very high interest rates, mortgage credit no longer is being used so extensively by home owners for purposes other than housing. Meanwhile, some slowing is apparent so far this year in the expansion of commercial mortgage debt, in accompaniment with the easing in construction of shopping centers and some other types of commercial building.

Municipal bond financing, on the other hand, set a record during the first half of 1980, even though it was off appreciably during the first three months, when soaring interest rates and adverse market conditions caused postponements of some planned issues. New mortgage revenue bonds in support of the housing market have been most responsible for swelling the volume of new offerings, but state and local government bonds for nearly all purposes rebounded strongly after the winter, as market conditions improved and interest rates came down. Besides the peak volume of bonds, a substantial amount of housing project notes have also been issued by states and municipalities this year.

An even more striking change in credit demands, however, is the explosive pickup since the winter in activity in the corporate bond market, which some market observers early in the year thought had lost permanent ground as a primary source of business financing. New public bond flotations during the first six months totalled almost $22½ billion, accelerating from $1.8 billion in March to $3 billion in April to $6 billion in May and to nearly $7 billion in June. This is well over twice the average monthly volume in 1975, the previous peak year for corporate bond financing. At the same time,

activity in the private placement market has more than matched that of a year ago.

Manufacturing companies have been responsible for much of the surge in corporate bond offerings. Recently, retailing firms also have been very active issuers of bonds as have finance companies and banks, and, of course, the utilities. In order to avoid being locked into the high interest rates, as well as to meet the current preference of investors, an increasing share—close to one half—of the bonds issued during the spring were medium-term issues. Along with the increase in bond financing, manufacturing and mining companies, in particular, have stepped up their issuance of common stock.

Heavy Government Financing Federal agency financing, too, has expanded by an unprecedented amount this year, mostly in support of the residential mortgage market but also to assist badly squeezed farmers, especially in obtaining long-term credit. Taken together, borrowing by Fannie Mae and the Federal home loan banks and by the Farm Credit Administration amounted to over $17 billion during the first half of 1980, $5½ billion higher than a year ago.

Reflecting the continuing rapid growth in Federal spending, but also a shortfall in Government tax receipts, financing by the Treasury so far in 1980 has been both greater than officially forecast and far larger than in 1979. Net Government borrowing from the public during the January-June period amounted to $24½ billion, compared with only $7¼ billion in the similar period last year.

Looking Ahead With aggregate economic activity still declining, unless a broadly based inventory bulge develops that requires extensive financing, which seems unlikely, the next several months doubtless will see continuing slack in overall short-term borrowing by business, the temporary strengthening of commercial and industrial loan demand at the large banks early in July notwithstanding. Similarly, while the sharp paydown of instalment debt recently and the complete removal of the Federal Reserve controls on credit suggest that most of the cutback in consumer credit may be behind us, it, too, will probably show no renewed growth, at least not until automobile sales pick up late in the year.

In all, short-term financing, exclusive of Government borrowings, is projected to amount to about $26 billion in the July-December period. This is down moderately from the first six months of the year and is well under half the amount of funds raised in the second half of 1979, when business activity was still expanding across a broad front.

Busy Bond Markets The bond markets, by contrast, give every indication of keeping very busy through the rest of 1980, though perhaps not on the scale of the past couple of months. Judging from the large corporate calendar, many more companies still are looking to refinance short-term debt and rebuild liquidity. Even with some cutbacks, as seems likely, capital spending programs—industrial as well as utility—will continue to require financing. And a number of managements evidently are relying more heavily on long-term debt now in order to leverage their equity and also to hedge against the perceived greater volatility of money market rates; for these and other reasons, several major companies recently have come to the bond market for the first time.

It would, therefore, not be surprising to see new offerings in the public market amount to as much as $18 billion in the second half of this year, which would make 1980 a record year—and by a sizable margin. Also as long as the stock market performs well, corporations will no doubt resort to equity financing on a significant scale in raising capital.

In all likelihood, too, the volume of municipal bond financing will be well maintained through the second half. Not all of the state and municipal bond issues postponed earlier probably have come to market. There is a need to finance ongoing construction projects and for underwriting industrial and public utility expansion programs. And almost surely the volume of state housing agency and mortgage revenue bonds will remain sizable; should the pending U.S. Senate resolution dealing with mortgage revenue bonds be adopted in its present form by the Congress, this would virtually guarantee a heavy volume of this type of financing through the remainder of the year.

In any event, the growth in residential mortgage debt should certainly pick up during the second half of 1980, although most likely it will remain comparatively restrained for a few more months. Sales of new homes rose sharply in May and housing starts jumped in June, and both probably will stay on an uptrend, now that mortgage interest rates have come down and home mortgage money is becoming more readily available. Meanwhile, commercial mortgage financing can be expected to expand further because of the high level of office building and hotel construction.

The Treasury's Needs Of greater importance is the step-up in Treasury financing in sight for the second half of this year. As a result of the rising level of Federal expenditures, particularly the larger unemployment compensation payments, the shortfall in tax receipts in response to the recession and

the failure of Congress to pass the President's proposed gasoline tax, the budget deficit for the current fiscal year is now officially projected to be as large as $60 billion. As a result, the Treasury will have to raise an estimated $22-25 billion in the July-September period. And because of the impact of the recession and for seasonal reasons, an additional $30 billion or so will probably have to be borrowed in the fourth quarter of this year.

Borrowing by the Federal agencies will most likely be down somewhat in the second half, as Fannie Mae and the Federal home loan banks will be cutting back on their financing, and, because of the seasonal reduction in the needs of the Federal intermediate credit banks and the Federal land banks, the Farm Credit Administration is expected to raise a smaller amount of funds than in the first six months. Even so, the amount of agency financing will still be sizable.

Taken altogether, the amount of funds expected to be raised in both the credit and capital markets during the July-December period is projected to total just short of $180 billion. This is $20 billion more than during the first six months of 1980, but it is $30 billion under the second half of 1979; for the private sector, the volume of financing will be down by some $50 billion, compared with a year ago.

Sources of Funds Some important changes, however, are in sight in the coming months among the major suppliers of funds to the credit and capital markets and in institutional investment policies.

GROWTH OF SAVINGS FUNDS
(In billions of dollars)

	1974		1975	1979	1980	
	1st Half	2nd Half	1st Half	2nd Half	1st Half (est.)	2nd Half (proj.)
Savings & loan ass'ns						
Net savings received	5.9	—.7	19.8	3.6	2.6	8.5
Interest credited	5.3	5.6	6.1	12.2	14.2	14.8
Total savings accounts	11.2	4.9	25.9	15.8	16.8	23.3
Mutual savings banks						
Net savings received	—.4	—2.4	4.3	—5.5	—3.5	1.0
Interest credited	2.8	2.9	3.0	5.0	5.2	5.5
Total savings accounts	2.4	.5	7.3	—.5	1.7	6.5
Money market funds						
Growth of assets	.3	2.0	1.4	19.3	30.8	12.5

First and foremost, while competitive pressures remain strong, especially from the money market funds, and the recovery in savings flows is expected to be slower than during the 1974-75 recession, because of the different position of the consumer today, the thrift institutions should see fairly sustained, even if only moderate, growth in their deposits from here on. Thus far, the savings and loan associations and mutual savings banks have repaid borrowings from the Federal home loan banks and elsewhere and rebuilt liquidity rather than re-enter the mortgage market on any scale; mortgage lending by the S&Ls in June was reportedly the lowest for the month in ten years. But as time goes on, and with their cost of funds having come down substantially, the thrift institutions can be expected to step up their mortgage lending. The expansion, though, is unlikely to be rapid.

Now that short-term borrowing costs have fallen to the point where policy loans and surrenders no longer are a growing problem, the life insurance companies, besides becoming more aggressive in making new commitments, are lengthening their investment portfolios. Thus, the corporate bond market stands to receive good support from this quarter in the coming months. Similarly, with the drop in money market rates the bond market should continue to attract support from the private noninsured pension funds. Not only is their cash flow being well maintained, but they still have some liquidity to draw on. And even though there is greater interest now in the stock market, the managers of these funds are continuing to place a good deal of emphasis on fixed income obligations in their investment strategies. State and local retirement funds, too, apparently still have room to lengthen their investment portfolios, and they have considerable incoming cash to invest. In view of their established preferance for the bond market, they are likely to be sizable buyers of corporates.

Likewise, the municipal market should continue to enjoy good institutional support, though perhaps not on the scale of the past few months. The commercial banks are showing somewhat greater interest in tax-exempt securities, what with business loan demand weak, a cutback in consumer borrowing and the increased need, on the part of some institutions at least, for tax-exempt income. At the same time, the municipal bond funds are still growing. And while inflation is eroding the underwriting profits of the fire and casualty companies, thereby lessening their need for tax-exempt income, they will surely remain the major supplier of funds to this market.

The large volume of Government financing in sight may not be quite as easily absorbed, in view of the fact that individuals

and noninstitutional investors will probably have less interest in this market, now that interest rates have come down so much. Still, commercial banks will be purchasers to some extent of Treasury securities, as well as tax-exempts, because of the sluggishness of loan demand. Businesses, as they rebuild liquidity, will certainly have an appetite for Governments. There no doubt will continue to be a demand for Treasury bills from the money market funds. In addition, foreign takings of U.S. Government securities presumably will be up in the second half, even if the dollar does not require extensive support.

Meaning for Interest Rates Prospective demand-supply conditions in the money and capital markets, as here projected, imply some further easing in credit market conditions and interest rates—but to a limited degree. As in recent months, however, the behavior of both money market rates and long-term yields will depend importantly on the reactions of investors to the course of the economy, particularly their perception of developments in the inflation arena, and on the actions of the Federal Reserve.

While the base rate of inflation is not expected to come down much, if at all, this year, and forthcoming events on the fiscal front also are not likely to be considered favorable from the standpoint of inflation, the consumer and producer price index numbers should make comparatively good reading for a while. This could encourage investors temporarily, even if there are further signs that the downturn in business activity is slowing.

As regards monetary policy, the expectation is that the Federal Reserve will continue to watch closely the current business statistics and the performance of the monetary aggregates, as well as financial market conditions here and internationally. But the Fed is concerned most with inflation. Having already fostered the steepest interest rate decline on record and having just completely dismantled the credit controls, chances are it will not ease very much, unless economic activity turns out to be far weaker than now seems indicated.

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Table 1
Net Funds Raised in the Credit and Capital Markets
(In billions of dollars)

	1974		1975		1979		1980	
	1st Half	2nd Half	1st Half	2nd Half	1st Half	2nd Half	1st Half (est.)	2nd Half (proj.)
Nonfinancial Sectors								
Short-term								
Bank loans to business[1]	20.3	11.0	—6.5	—.3	24.5	18.2	9.5	4.5
Open market paper	5.9	8.0	—1.4	—1.0	8.7	13.5	18.0	12.5
Finance company loans to business	2.3	2.5	1.5	.6	7.0	.1	.5	.2
Total business credit	28.5	21.5	—6.4	—.7	40.2	31.8	28.0	17.2
Consumer instalment credit	3.6	6.0	—2.6	10.3	16.2	19.2	—6.0	3.0
Other types of bank loans	3.9	2.6	—3.3	1.8	2.3	10.7	2.5	1.0
Life insurance policy loans	1.1	1.6	.9	.8	2.0	2.6	4.5	2.2
Farm credit agency loans	1.4	1.2	1.0	.5	2.3	1.7	2.1	1.4
State and local notes[2]	2.1	.6	1.1	—2.8	—.7	.8	1.5	1.0
Total	40.6	33.5	—9.3	9.9	62.3	66.8	32.6	25.8
Investment								
Corporate bonds	9.1	10.6	17.7	9.5	10.3	10.8	19.8	16.0
State and local bonds	8.2	6.2	7.3	8.0	9.3	11.9	13.3	12.0
Corporate stocks	2.5	1.7	6.0	5.2	1.4	2.1	3.3	3.5
Foreign bonds and stocks	.9	1.1	3.0	3.5	1.6	3.2	1.6	2.0
Mortgages	34.7	25.5	26.0	33.0	78.3	82.4	63.0	67.0
Total	55.4	45.1	60.0	59.2	100.9	110.4	101.0	100.5
U.S. Government[3]								
Treasury securities	—3.4	15.2	36.4	49.4	7.2	31.5	24.6	52.0
Budget agencies (Ex-Im Bk, GNMA, TVA, etc.)	.5	—.6	—.3	--	—1.0	—.1	—.1	—.1
Total	—2.9	14.6	36.1	49.4	6.2	31.4	24.5	51.9
Total	**93.1**	**93.2**	**86.8**	**118.5**	**169.4**	**208.6**	**158.1**	**178.2**
Financial Sectors								
Open market paper	2.1	.2	.1	.7	12.6	5.8	.8	.5
Corporate bonds	2.5	2.9	2.6	2.1	5.7	2.2	5.5	4.5
Corporate stocks	.3	—.2	—.8	—.1	1.0	1.0	.4	.5
Nonbudget agencies (FHLB, FNMA, FFCA, FHLMC)	5.6	11.0	—.4	2.9	11.5	12.7	17.0	13.5
Total	**10.5**	**12.9**	**1.5**	**5.6**	**30.8**	**21.7**	**23.7**	**19.0**

[1] Includes corporate and noncorporate business, domestic and foreign, and agriculture.
[2] Includes tax-exempt commercial paper.
[3] Publicly held

Table 2
Financing Business Corporations
(In billions of dollars)

	1974		1975		1979		1980	
	1st Half	2nd Half	1st Half	2nd Half	1st Half	2nd Half	1st Half (est.)	2nd Half (proj.)
Cash Flow								
Undistributed profits	18.9	20.2	13.4	21.7	37.2	39.1	39.5	26.5
Capital consumption allowances	37.6	39.4	41.2	42.9	60.4	63.4	66.5	69.0
Total	56.5	59.6	54.6	64.6	97.6	102.5	106.0	95.5
Physical assets								
Plant and equipment	53.9	59.1	51.9	55.0	92.6	104.9	106.0	104.0
Inventories—book value	24.6	28.7	—1.6	3.7	31.6	27.3	25.0	9.0
Residential structures	1.3	.9	.5	1.5	1.1	3.4	--	1.5
Total	79.8	88.7	50.8	60.2	125.3	135.6	131.0	114.5
Physical assets less cash flow	*23.3*	*29.1*	*—3.8*	*—4.4*	*27.7*	*33.1*	*25.0*	*19.0*
Loans and securities								
Bonds	9.1	10.6	17.7	9.5	10.3	10.8	19.8	16.0
Tax-exempts	1.4	1.1	1.5	1.5	1.7	2.4	1.8	2.0
Stocks	2.5	1.7	6.0	5.2	1.4	2.1	3.3	3.5
Mortgages	7.9	5.9	3.1	6.5	10.5	13.4	7.5	8.5
Bank loans	19.0	11.3	—7.6	—3.4	23.7	15.8	6.5	2.5
Open market paper	2.0	3.4	—.9	—1.8	5.4	4.5	13.0	8.5
Finance company loans	2.7	3.1	1.7	.5	6.9	.1	.5	.2
Total	44.6	37.1	21.5	18.0	59.9	49.1	52.4	41.2
Other sources of funds								
Direct foreign investment	1.7	2.0	.6	.8	1.4	2.4	2.5	2.0
Unpaid taxes	—1.4	2.5	—7.3	4.8	—6.9	8.9	—4.5	1.5
U.S. Government loans	--	1.6	--	.2	.6	.6	.5	.5
Total	.3	6.1	—6.7	5.8	—4.9	11.9	—1.5	4.0
Other uses of funds								
Liquid assets	—1.8	7.8	2.8	16.9	.9	18.7	5.5	11.5
Investments abroad	—4.1	5.2	4.4	1.6	3.7	1.2	1.0	1.5
Net trade credit	17.5	—13.8	6.8	—6.8	13.2	—8.3	10.5	—4.5
Total	11.6	—.8	14.0	11.7	17.8	11.6	17.0	8.5